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SUBJECT: ICELAND: NEW FOREIGN EXCHANGE RULES EASE TRADE AND HELP
CURRENCY APPRECIATE

1.(SBU) Summary: The Icelandic Central Bank implemented new Rules on Foreign Exchange on December 4, removing some of the restrictions placed on access to foreign currencies in October after the collapse of the banking sector. The new Rules generally allowed access to currency for trade purposes but not for investment or speculation in the krona. This limited float resulted in a quick 25 percent appreciation of the krona. On December 16, the Rules were revised to allow for exemptions in certain circumstances such as overseas investment. Economists and business representatives tell us they are not happy with the arrangement and that the currency should be allowed to float freely. End Summary.

12. (SBU) Following the collapse of the banking sector in October, the Central Bank took over all foreign exchange transactions in Iceland. On October 15, it imposed immediate restrictions that rationed out foreign currencies and gave priority access to currency to importers of food, pharmaceuticals and fuel. Everyone else literally had to get in line for foreign exchange and make a case of need. On November 28, the Althingi (Parliament) passed new Rules on Foreign Exchange, which modified the restrictions and confined capital outflow. The Rules freed up access to foreign currencies for any trade purposes, but forced Icelandic businesses to repatriate export-generated currency and restricted access to currency to be used for overseas investments.

13. (SBU) By restricting the outflow of capital, while allowing it to flow in, the Government was able to support the value of the krona in a partial float. The result was a quick 25 percent appreciation over three days. The Rules also prevented foreigners involved in the carry trade from cashing out of their krona denominated investments in exchange for foreign currency and kept Icelandic businesses who wanted to invest abroad in areas other than real estate from getting access to exchange.

14. (U) On December 15, the Central Bank, with the Ministry of Commerce's approval, implemented a revised set of Rules on Foreign Exchange, which allowed for exemptions. These revisions allowed companies with 80 percent of revenues and expenses abroad to apply for exemptions such as permission to get access to currency for investment or to not return export generated currency. The Central Bank said in a press release that companies would be granted exemptions from the Rules because of "critical interests at stake" and because the exemptions would be unlikely to cause volatility in the exchange rate. Still prohibited is the movement of capital from Iceland generated by the sale of direct investments (i.e. the carry trade).

15. (SBU) Director of the University of Iceland's Economic Institute Gunnar Haraldsson thought it would have been better to let the krona float freely. He likened the current situation to a system that was in place 30 years ago. He noted that companies were pretty successful in working past the restrictions at that time, and that

they would likely be able to do the same today. Haraldsson said it is very hard to control markets and the restrictions, even with the new modifications, are "not intelligent." Managing Director of the Chamber of Commerce Finnur Oddsson criticized the new regulations and doubts their usefulness. Oddsson said the new regulations will hinder normal reconstruction of the Icelandic business sector and will damage Iceland's reputation for a long time. Oddsson said the modifications implemented on December 16 had little effect on the Chamber's view of the restrictions.

VAN VOORST